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Mexico: Mixed Prospects for Nonoil Exports

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An Intelligence Assessment

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ALA 84-10096
October 1984

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Mexico: Mixed Prospects for Nonoil Exports [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] 25X1
Office of African and Latin American Analysis. It was coordinated with the Directorate of Operations. [redacted] 25X1

Comments and queries are welcome and may be directed to the Chief, Middle America–Caribbean Division, ALA, [redacted] 25X1

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Mexico: Mixed Prospects for Nonoil Exports

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Key Judgments

Information available as of 20 September 1984 was used in this report.

Mexico, in our view, is unlikely to achieve the expansion of nonoil exports crucial to President de la Madrid's efforts to revitalize the economy. As long as the Mexican Government remains unwilling or unable to shift its policies toward the kind of external-oriented development that characterizes, for example, South Korea or Taiwan, its nonoil export prospects will be constrained. The economy will continue to be pulled by swings in oil markets, world demand for its limited number of other exports, and bankers' willingness to continue to supply credit to cover current account deficits.

Steps begun in 1982-83 to spur foreign sales as a way to handle Mexico's severe debt repayment problems—such as devaluation, new trade credit mechanisms, and reduced regulation—have been only partially effective and the impact is diminishing:

- Complex and unpredictable exchange rate policies make it difficult for export firms to make investment and production decisions, while the failure of the government to keep the exchange rate for the peso at its real value makes Mexican exports less competitive in world markets.
- Mexico's financial crisis, now into its third year, has reduced the availability of foreign and domestic credit that can be used to expand exports.
- For political reasons the structure of the economy continues to be oriented toward import substitution and protection for domestic industries, which boosts costs for exporters.
- The government has yet to define and protect the role of the private sector in the economy vis-a-vis that of state corporations, which discourages export investment.

Until both local and foreign businessmen become confident that economic policies will be favorable and steady, they will limit their investment in export industries. As a result, we foresee no probable circumstances that would allow nonoil exports to quadruple by 1988, de la Madrid's target announced last year. Mexico City has recently played down this goal, as evidenced by policy statements published this summer that call only for a doubling of nonoil exports.

We believe this more modest goal is possible if, but only if, the government keeps the peso competitive. Our analysis shows that the exchange value of the peso is the primary determinant of Mexico's nonoil export growth. We project export growth of 17 percent in 1984, paced by the rapid expansion of postrecession foreign demand for manufactured goods, and 10 percent

25X1

annually thereafter. In our most likely case, we foresee nonoil exports growing at a compounded rate of about 90 percent in 1983-88, driven largely by sales of automotive parts and engines, electronic and mechanical equipment, steel, processed foods, chemicals, and telecommunication equipment.

On the other hand, appreciation of the peso could reduce the growth of nonoil exports to less than 10 percent annually. This is a real danger because Mexican officials are reluctant to devalue the peso fast enough to keep it competitive, in part because they want to break the public's inflationary expectations. In addition, after two years of austerity, the government needs the political payoff that would come from a high peso value to restore imports of capital goods for domestic industries and to keep the private-sector's debt repayment burden manageable.

Other political considerations will also dampen export prospects. We believe de la Madrid will avoid sensitive policy changes in advance of the important midterm federal and state elections next year. This will prevent him, for example, from dismantling protectionist policies because the short-run political costs of a probable increase in business failures and higher unemployment outweigh the future benefits in export growth.

Besides its own policy constraints, the government's desire to expand nonoil exports is limited by external factors:
- The large, oil-generated trade surpluses Mexico has with many industrial countries, including the United States, will limit these countries' willingness to expand their purchases of other Mexican products.
- Many Mexican exports, such as steel and textiles, face stiff competition from industrial country and Third World producers.
- The outlook in other LDCs' markets is poor because many of the potentially largest purchasers, such as Brazil and Argentina, are reeling from their own financial difficulties and have had to restrict imports.

The pace of Mexico's economic activity will clearly remain sensitive to changes in sales of its principal oil exports. If the revised reserve estimate in a recent Department of Energy study are at all on the mark, oil revenues are likely to be lower than planned and de la Madrid will find his policy choices increasingly constrained. Under these conditions, we believe that chances are better than even that during the second half of his administration (1986-88) de la Madrid will follow in the footsteps of his predecessors

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25X1

and rely on traditional populist policies and government spending to reflate the economy. Too broad-based reflation would boost short-term growth and be politically helpful, but would be likely to set back nonoil export growth and generate another financial crisis for his successor.

Given what we judge to be Mexico's optimistic targets, trade issues are especially likely to play a large and contentious role in US-Mexican relations over the next several years. Mexico is hardening its position against joining GATT and will continue to resist calls for reciprocity in bilateral trade deals with the United States. Even so, Mexican officials are convinced that better access to the US market is essential and will keep pressing for the special trade relationship they feel is necessary to encourage new investment. Mexican officials will also lobby hard for renewal of the concessions the US Generalized System of Preferences (GSP) program provides them. In our judgment, however, structural changes in the Mexican economy and maintenance of a competitive exchange rate would contribute more to expanding sales to the United States than a more liberal GSP or a bilateral trade treaty. 25X1

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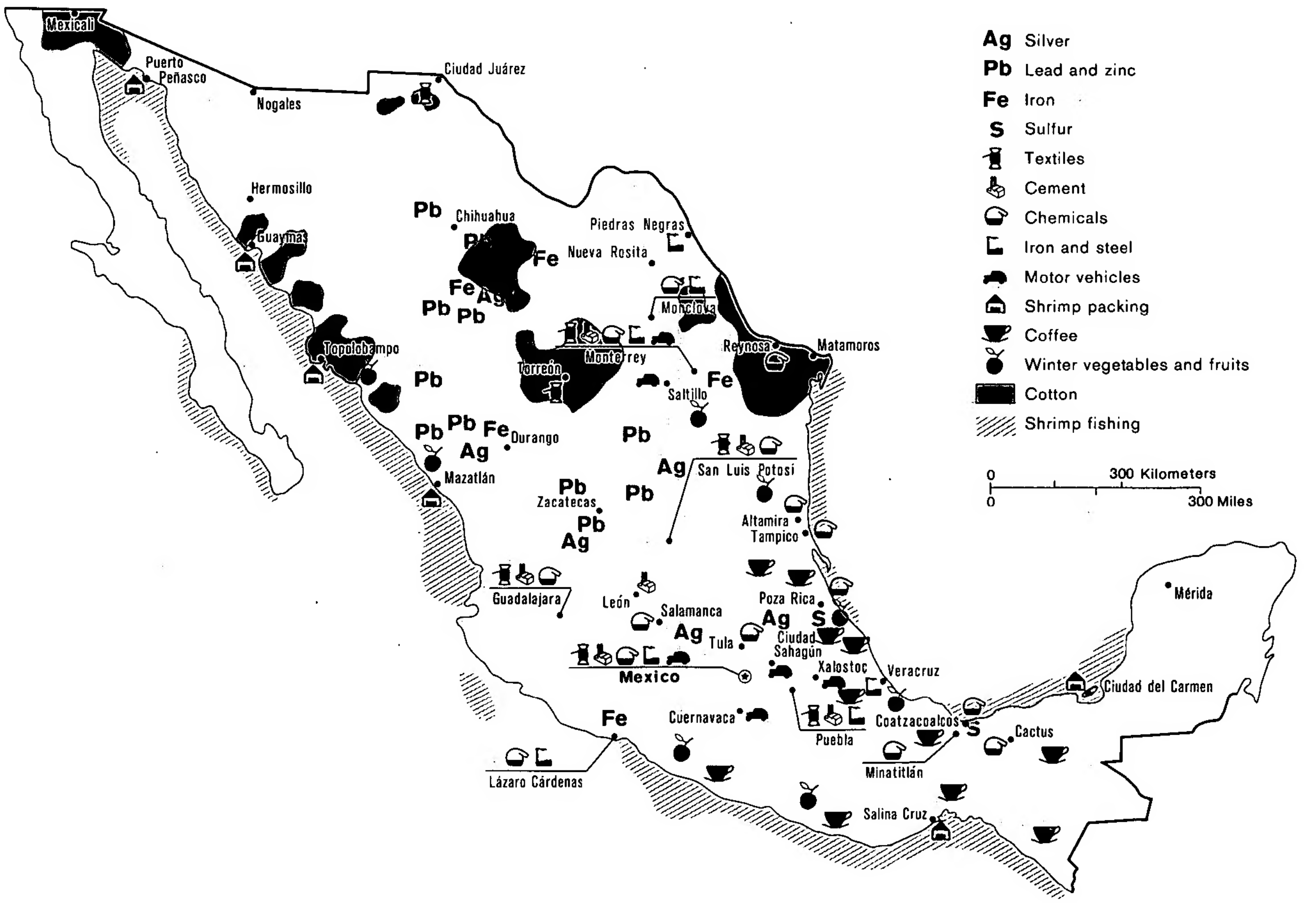
Contents

25X1

Mexico: Nonoil Exports



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Mexico: Mixed Prospects for Nonoil Exports [redacted]

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Introduction

President de la Madrid has called the expansion of nonoil exports crucial for revitalizing the economy. Higher foreign sales would help rebuild import and debt service capacity, stimulate an economic expansion, and create job opportunities for the more than 900,000 young Mexicans who enter the labor market each year. Nevertheless, bureaucratic missteps, policy contradictions, and the lingering financial crisis have dampened the export drive. Moreover, structural changes necessary for sustained improvement in nonoil export performance have so far been lacking. Recently, the President appeared to play down his goal of quadrupling nonoil exports in 1983-88, as recent policy statements have contained only a more modest call to double nonoil exports. [redacted]

This paper assesses the short- and medium-term prospects for nonoil exports by examining changes in economic policy introduced during de la Madrid's first 18 months in office and reviewing past export trends. We used econometric tools to project nonoil export growth through 1988 under alternative scenarios for exchange rates and US economic performance. The appendixes provide details of earlier, largely unsuccessful, efforts to promote nonoil exports and information on the econometric model. [redacted]

De la Madrid's Inheritance

Over the last 30 years, Mexico largely ignored its export sector in favor of import substitution. Successive administrations used a variety of direct and indirect means—including high tariffs, import and export licensing, and subsidies—to encourage production of consumer goods for local markets. These policies assured domestic manufacturers and farmers protection from foreign competition, stimulated rapid capital formation, and helped Mexico to achieve an average annual 6.5-percent economic growth rate during 1951-81. Entrepreneurs had no incentive to export. [redacted]

Nevertheless, as early as the 1960s, Mexico City realized that easy import substitution possibilities were running out and industrial development plans began to call for a new growth strategy based on export promotion. The programs, however, were never fully implemented or were contradicted by fiscal and monetary policies that continued to favor import substitution. Fiscal incentives such as tax rebates and credits, for example, encouraged capital-intensive investment despite Mexico's dependence on imported capital goods and its surplus labor supply. The rapid development of oil resources beginning in the mid-1970s pushed growth to record levels but also absorbed a large share of investment resources. A steadily appreciating peso—buoyed by new oil earnings—helped domestic producers by making capital and intermediate goods imports relatively cheap, but nonoil exports became less and less competitive. In addition, increasing oil revenues and greatly expanded foreign borrowing in the 1978-81 period helped spur a sharp increase in consumer spending and allowed both import substitution industries and imports to expand. While the economy grew at an annual rate of 8 percent during this time, nonoil exports fell in real terms, the trade deficit soared, and inflationary pressures mounted. [redacted]

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Lopez Portillo abandoned even the rhetoric of export promotion in his fifth state of the union address in September 1981. He called for manufacturers to concentrate on import substitution because of "the unreliability of foreign markets" that were now well into the 1980-83 global recession. To cope with financial problems brought on by softening oil prices and mounting government deficits, Lopez Portillo tightened import and export license requirements in late 1981 as the current account raced toward a $13 billion deficit. Even with the sharp peso devaluations in 1982, nonoil exports fell by more than 10 percent (contributing only 25 percent of total export revenues compared with 86 percent in 1976) as policies discouraging exports were reinforced by the worldwide recession, falling commodity prices, and the 1982 Mexican drought. [redacted]

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As part of Mexico City's promotion campaign airmail stamps advertise export products

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Turning to Exports

On assuming office in December 1982, de la Madrid promised a new economic direction to restore health to the economy. To promote long-term improvement in Mexico's foreign accounts, he publicly proposed to wean the economy from its reliance on oil exports, foreign lending, and import substitution by implementing a growth strategy based on boosting nonoil exports. The new President announced an export promotion program in May 1983 that set a goal of quadrupling nonoil exports to more than $20 billion by the end of his administration in 1988. Subsequently, he laid out an agenda for encouraging nonoil export development in the National Development Plan (NDP) published in June 1983,[1] which included maintaining a competitive exchange rate, eliminating regulatory barriers, improving relations with the alienated private sector, and helping distressed businesses regain access to peso and foreign exchange credits.

Moves Toward Export Expansion

Exchange Rate Policies. De la Madrid moved quickly to realign Mexico's foreign exchange policies. In December 1982 he sharply devalued the peso and eliminated some of the more onerous exchange restrictions imposed by his predecessor. The President introduced a dual exchange rate and ended the previous administration's experiment with multiple floating and pegged rates. Under the new system, importers of critical items and those companies with foreign debt obligations were allowed to buy dollars in the "controlled" foreign exchange market where fewer pesos were required to purchase dollars than in the free market. While this practice eased the adjustment to the devaluation for a few, exporters were also required to turn in their dollar earnings at the controlled exchange rate, which diluted some of the benefits of the devaluation, discouraging exports. 25X1

As the availability of foreign exchange improved this year, Mexico City made it easier for businesses to obtain foreign exchange: 25X1

- The government eased regulations covering the conversion of earnings from foreign sales by allowing exporters to use up to 100 percent of their revenues directly to meet their own foreign debt obligations.
- It extended from 30 days to as much as 120 days the time that exporters were given to deposit their foreign revenues in Mexican banks.
- The controlled exchange market was opened to all registered importers, which enabled export producers to obtain needed imports of intermediate and capital goods. 25X1

Regulatory Relief. Regulations covering export licenses also have been gradually liberalized. Permits are no longer required for about 90 percent of exports, and most export tariffs have been reduced or eliminated. More recently, as the financial situation improved, Mexico City removed import license requirements for most intermediate and raw materials used in products produced for export. 25X1

Restoration of Trade Credit. The de la Madrid administration's moves to clear up its debt repayment moratorium and private-sector debt arrearages have restored partial access to trade credits that had nearly halted in late 1982. Mexico City has tapped multilateral lenders and foreign governments for funds to expand its own export financing programs. The World Bank, for example, has announced it will channel $625 million in new and reprogramed funds to exporters at preferred rates. According to US Embassy reporting, the budgets of Bancomext, the foreign trade bank, and FOMEX, the government's export promotion fund, were sharply increased to provide additional peso and dollar loans to the private sector. These government institutions also have arranged buyer credits with banks in 18 countries to finance Mexican sales. The willingness of the government's large development banks to act as intermediaries in 25X1

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[1] See table 5, foldout at back inside cover, for a list of frequently used acronyms in this paper.

distributing and guaranteeing new funds has been vital, because creditors are unwilling to lend directly to private enterprises.

To facilitate private rescheduling exercises and restore normal trade credits for Mexico's private sector, Mexico City set up FICORCA, a trust fund within the Bank of Mexico that grants access to foreign exchange at subsidized rates to firms that successfully reschedule their debts. According to press reporting, by December 1983 debt rescheduling negotiations for $12 billion of $16 billion in private debt had begun under FICORCA auspices. Early in 1984, the trust fund extended coverage to other categories of private debt.

Other Measures. The government has taken a number of other steps to promote exports. President de la Madrid folded export-related programs previously administered by a number of agencies into the Foreign Trade Institute (IMCE), which established a one-stop "single window" program to advise exporters on Mexican and foreign regulations and increased its technical services. The financial press has noted stepped-up IMCE promotion efforts in 1983 and early 1984 through trade missions and participation in trade fairs. In addition, the government instituted a "buy Mexico" campaign and, according to the press, plans to purchase 65 percent of budgeted goods and services from domestic sources; the administration hopes this program will prod local producers to meet international quality standards so they can expand sales to foreign markets.

Performance to Date

Nonoil merchandise exports have advanced broadly under the de la Madrid administration, although not to targeted levels. In 1983, nonoil merchandise exports grew 11 percent from $5.6 billion in 1982 to $6.2 billion. An examination of Mexican trade statistics shows that manufactured exports have grown most rapidly while agricultural products increased modestly and unprocessed minerals barely rose at all:

- *Manufactures* sold abroad—excluding exports from in-bond firms—increased by 21 percent in 1983. Metallic products and equipment exports grew by 21 percent with cars, auto parts, and engines showing the biggest gain, some 37 percent. The 52-percent jump in steel exports triggered some trade actions in the United States. Exports of nonmetallic mineral products, mostly glass goods and cement, rose by 46 percent. Sales of chemicals grew 10 percent. Exports from border assembly plants increased by 31 percent last year.[2]

- *Agricultural* exports showed a modest 4-percent gain from 1982. The 41-percent increase in sales of crude and processed coffee accounts for the bulk of the increase. Important cotton and tomato exports, on the other hand, fell about $50 million each. These and other crop sales were off in part because of the 1982 drought and because higher input costs due to inflation and peso devaluations affected production.

- *Mineral* exports fell by 11 percent last year. Although prices for most of Mexico's principal metal exports were up slightly, earnings were off 33 percent as sales volume dropped. This decline resulted from customers drawing on stockpiles built up during the worldwide recession, competition from other metal exporters, and a Mexican switch to processed mineral exports, which Mexico City counts as manufactured exports. Nonmetallic mineral exports were up 31 percent, mostly as a result of a 46-percent increase in earnings from sulfur exports.

- Service receipts from *tourism* and frontier transactions[3] fell by 12 percent in 1983. Tourism earnings from the interior of Mexico increased 16 percent in 1983 as the devaluations combined with controlled hotel prices made Mexico competitive with Caribbean vacation alternatives. The gain was more than offset by a decline in frontier earnings, which fell by 28 percent largely because of the devaluation. Slower economic recovery in the US border area and shortages of goods imported into this duty-free zone for resale also contributed to the decline.

[2] This figure represents only border industry sales to the United States, the bulk of such sales. The value added in Mexico declined by 3 percent in 1983 because peso devaluations reduced wages in dollar terms.

[3] Frontier transactions refer to economic activity in the 20 kilometer strips along Mexico's borders with the United States and Guatemala. Money spent by day-trippers visiting Mexico from the United States represents the bulk of earnings in this sector.

Mexico's Nonoil Exports: A Profile of Traditional and Growth Areas

Mexico has traditionally exported a wide variety of goods, although oil began to dominate earnings after the mid-1970s. Coffee, cotton, and shrimp exports were the principal sources of foreign exchange prior to the oil boom. Mineral exports, including silver, copper, sulphur, zinc, fluorspar, and lead, were also major generators of income. Traditional manufactured exports include electronic equipment, textiles, machinery and metal products, and chemicals.

Manufactured Goods
We believe that future expansion in nonoil exports will depend largely on manufactured goods. Based on past trends and current policy directions, auto parts and engines, electronic and mechanical equipment, steel, processed foods, chemicals, telecommunications equipment, synthetic fibers, and possibly small computers will grow fastest. Two US automobile firms completed engine plants in 1981 that will export 75 to 80 percent of production. Two other car firms have new export plants scheduled for completion in the mid-1980s, and another plans to use Mexico for export. Several US computer firms have recently built or have government authorization for new plants, and most plan to export to the Latin American market. Mexico has substantial installed capacity in the chemical, electronic, and steel industries, and depressed local demand is forcing these industries to look for new markets abroad.

In-bond assembly plants,[a] which export finished products under special tariff concessions, have particularly strong export potential, as long as favorable US tariff provisions are not rescinded. The in-bond plants export a wide variety of products including electronic components, auto parts, medical supplies, television chassis, sports equipment, and textile products. The majority of the plants are US owned, but some Japanese electronics and auto parts firms have recently established in-bond facilities, and, according to a US Embassy report, German and Spanish firms have expressed some interest. Peso devaluations and renewed consumer demand in developed economies are spurring investor interest. Wage rates averaging around $1.00 per hour and proximity to the United States make Mexico extremely competitive with assembly industry in Asia. 25X1

Natural Resources
Mineral exports will continue to be important, but factors beyond Mexico City's control, principally the level of OECD capital investment, will largely determine earnings. Miniaturization, synthetic material substitution, excess production capacity of some metals, and competition from other cash-strapped LDCs also will restrain sales increases in the long run. 25X1

Domestic agricultural policy and external constraints will hinder the growth of food exports, although sales of coffee, cocoa, beef, and shrimp should increase. Mexico City continues to emphasize self-sufficiency and has shifted agricultural trust fund credit from large irrigated farms in the northwest to smaller, less competitive farms in the south, according to US Embassy reporting. Productivity has also been affected by sharply increased farm input costs. Additionally, droughts periodically reduce agricultural production. Exports also often run afoul of trade barriers such as tariffs and environmental controls. 25X1

Services
Tourism should continue to improve, and a recent World Bank study predicts a small increase in the export of technological services. In April of this year, Mexico City announced that hotel rates would remain constant for the year. According to the press, the Tourist Ministry also strengthened enforcement of price and quality controls. Exports of technological services would include construction and oil-drilling services and the sale of technology such as a direct reduction steel process developed by a Monterrey firm. 25X1

[a] *Also commonly referred to as Border Industries.* 25X1

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Table 1
Mexico: Balance of Payments, 1981-85

Million US $

	1981	1982	1983 [a]	1984 [b]	1985 [b c]
Current account balance	−12,544	−4,879	5,546	3,700	1,800
Trade balance	−3,003	7,644	14,508	14,100	10,800
Exports, f.o.b.	20,927	22,081	22,228	23,600	24,800
Oil and gas	14,573	16,477	16,002	16,300	16,700
Manufactures	3,665	3,869	4,494	5,300	6,000
Agriculture	1,481	1,233	1,285	1,400	1,450
Minerals	1,208	502	447	600	650
Imports, f.o.b.	23,930	14,437	7,720	9,500	14,000
Net services and transfers	−9,541	−12,523	−8,962	−10,400	−9,000
Interest	−8,383	−11,264	−9,861	−11,400	−12,000
Debt amortization due	6,629	8,000	9,000	8,000	9,700
Financial gap	**−19,173**	**−12,879**	**−3,454**	**−4,300**	**−7,900**
New medium- and long-term capital inflows	18,325	15,700	8,500	6,000	4,000
Rescheduled medium- and long-term debt payments		2,000 [c]	28,700 [c]	6,000 [c]	8,000 [c]
Net short-term capital	10,233	356	−29,208 [d]	−1,000	NEGL
Errors and omissions	−8,373	−8,362	−1,432	−3,000	−2,000
Changes in reserves	−1,012	−3,185	3,106	3,700	2,100
Other financial items					
External debt (at yearend)	75,061	87,875	90,000	96,000	98,000
Short term	22,654	28,641	10,000	9,000	9,000
Debt service ratio (*percent*)					
Due	48.7	66.6	66.7	60.0	
After debt relief	48.7	59.7	41.9	40.0	

[a] Estimated.
[b] Projected.
[c] Includes debt relief on $2 billion in 1982, $7 billion in 1983, $6 billion in 1984, and $8 billion in 1985 on medium- and long-term debt principal due; and $22 billion in 1983 in short-term debt rescheduled as long-term obligations.
[d] Includes rescheduled short-term debt.
[e] This projection was based on assumptions described in our most likely case.

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First-quarter 1984 trade data—the latest available—indicate a continuation of the modest 1983 nonoil merchandise exports advance. Nonoil exports, excluding border industries, accounted for $579 million in sales in January, $633 million in February, and $628 million in March. Although this is only slightly above the previous record of $604 million in December 1983, the first-quarter figures are nearly half again the level of the first quarter of 1983, when Mexican industry was in disarray. Unlike last year when manufactured exports led the advance, this year official figures indicate that agricultural and mineral sales are keeping pace. 25X1

Export earnings from services are up a little, in large part reflecting a substantial jump in tourism in the first quarter. Income from border industries is 17 percent above last year's pace. On the other hand, receipts from frontier transactions are nearly one-fourth below last year's depressed levels. [redacted]

Remaining Barriers to Export Expansion

Despite the progress to date, the potential for export expansion has been blunted by remaining government restraints and uncorrected policies. In our view, the most important of these is a failure to maintain exchange rate adjustments that reflect the true value of the peso. In addition, exporters face continuing regulatory barriers, protectionist policies, and an inward-oriented economic structure, all of which boost their costs and decrease the competitiveness of Mexican goods sold abroad. [redacted]

The Appreciating Peso

Although Mexican officials have frequently stated publicly that exchange rate policy will be the principal tool for promoting exports, the immediate priority of reducing inflation has encouraged appreciation of the peso. Over the course of the past 22 months, exporters have seen their exchange advantage steadily decline. Since the last maxidevaluation in December 1982, consumer prices have increased by more than 150 percent, while the peso value of export earnings has risen only 95 percent, according to our calculations. [redacted]

As things now stand, a further erosion in the peso's competitive position seems likely. Inflation is presently running at an annual rate of 70 percent, and both we and the US Embassy calculate that December-to-December inflation is likely to be in the 55- to 60-percent range. At the same time, the peso is being devalued at an annual rate of only 33 percent. [redacted] Mexican officials insist that the daily slide will not increase since Mexico City has enough reserves to support the peso, at least temporarily. [redacted]

Impact of Exchange Rate Changes

To test our view that Mexico's exchange rate policies are inhibiting exports, we used an econometric model to simulate the impact of exchange rate movements—and other factors—on export performance. In general, the CIA model shows that the Mexican economy is most sensitive to movements in the exchange rate. Because the peso moves with ease back and forth along the border, Mexico is directly affected by US monetary policy through its exchange regime. Devaluing the peso nearly 10 percentage points faster in 1984-85—using our calculation of the difference between Mexican and US inflation rates—produced dramatic improvements in growth and nonoil export performance. The economic decline slows substantially in 1984, and economic growth approaches 5 percent in 1985, exceeding Mexico City's optimistic 3- to 4-percent growth projection. Nonoil export sales also jump by nearly 2 and 5 percentage points in 1984 and 1985, respectively. The model demonstrates that an overvalued exchange rate is a drag on the economy. If the peso appreciates significantly, economic activity declines in both 1984 and 1985. [redacted]

Persistent Regulatory Problems

An overvalued peso is not the only problem Mexican exporters face. Many barriers to exports remain on the books despite the new attention to the issue. Although the IMCE "single window" service was originally intended to process all the exporter's paperwork, press [redacted] sources say exporters are still wrapped in redtape. Businessmen still are required to deposit export receipts with the Bank of Mexico; according to press reports, this and other exchange regulations are causing increased use of underinvoicing and the government estimates between 10 and 15 percent of nonoil exports go unreported. Credit to the private sector from the newly nationalized banks is also sharply below prenationalized levels; [redacted] press reporting suggests that the lack of clearly defined lending policies by the banks and businessmen's distrust of the national banks have contributed to the problem. [redacted]

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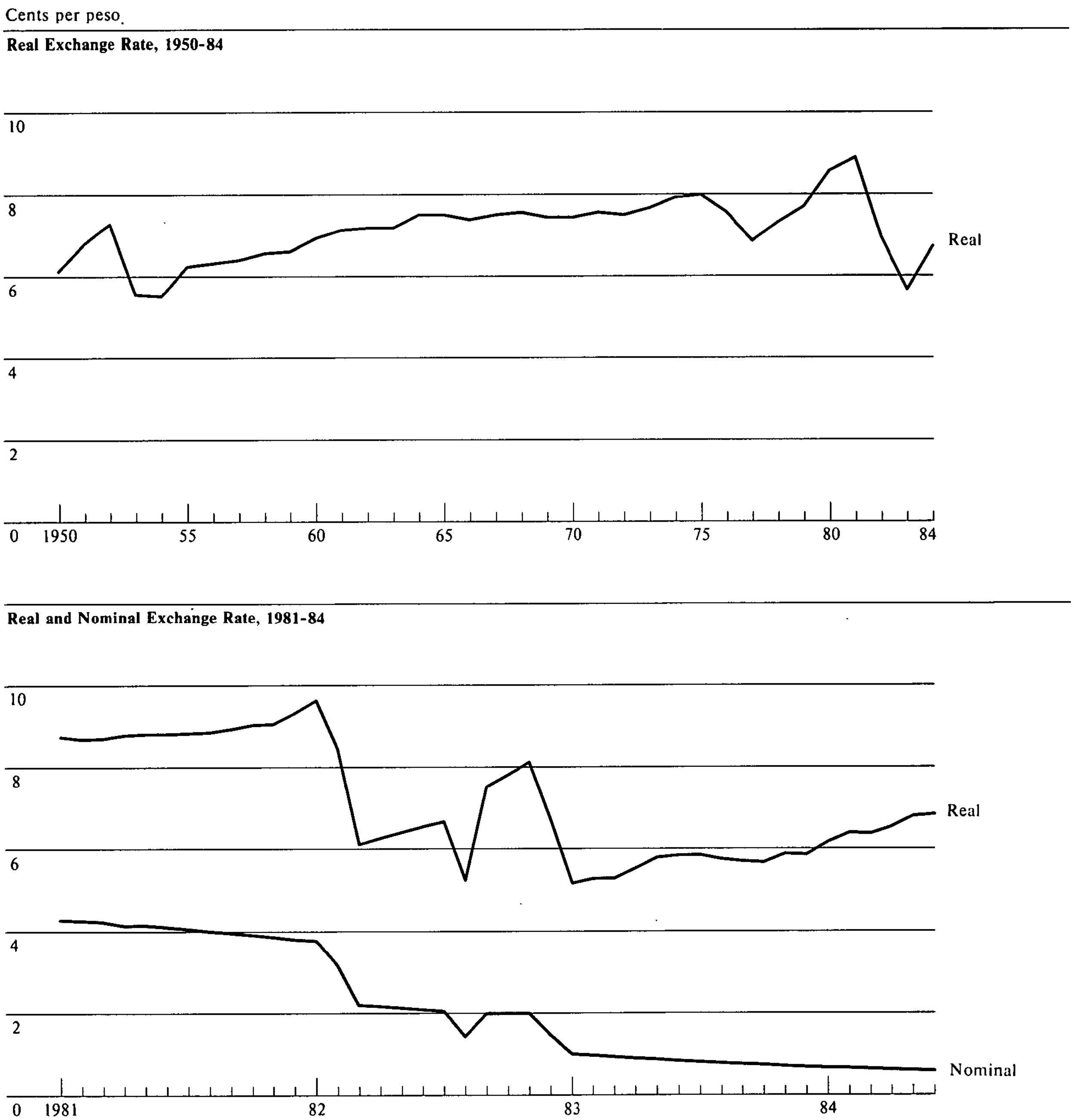
Figure 1
Mexico–United States: Peso/Dollar Exchange Rates [a]



[a] Real in 1975 prices.

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Price controls, credit policies, and tariff and trade regulations on the books from previous administrations are strongly biased in favor of production for the domestic market. Mexico City has made gestures toward change, such as recently establishing a commission on public-sector prices and tariffs to analyze the policy effect on production and income distribution, and announcing a National Program for Financing Development in June 1984. The administration also has promised the IMF that it will introduce extensive tariff reforms later this year. [redacted]

We doubt, however, that the government has the will to make substantial changes, and marginal adjustments will not be enough to encourage exporters. The National Program for Financing Development, for example, is vague on how additional funds will be channeled to the private sector. In our judgment, policymakers recognize that pricing and credit distribution policies are inefficient, but feel locked into them by political exigencies. Mexico City's plan to increase agricultural credits to smaller, less efficient farms in the south, for example, complements the Southern Development plan, which was conceived for political and security motives, but diverts credit from the large, irrigated, export-oriented farms in the northwest, according to embassy reporting [redacted]

We expect that changes in credit and price policies will come only slowly, if at all, as competing groups lobby to maintain beneficial programs. For example, state-owned firms—which are often unprofitable because of public-sector pricing policies—are likely to absorb high levels of credit preempting funds from the private sector. Small and medium import substitution firms also will lobby for the continuation of a variety of credit, price, and tax programs that allow them to stay competitive. Government-affiliated labor groups continue to press for price controls in exchange for accepting real wage cuts in 1983 and 1984. [redacted]

Structural Problems

In addition to government policy disincentives, local firms face several structural roadblocks. Mexican producers remain oriented to the internal market, with exports long considered a sideline. Most industrialists have no foreign marketing skills and lack access to foreign distribution systems. Moreover, in the highly protected internal market, according to academic studies, domestic sales have often yielded profits three times those from sales abroad. In these 25X1
circumstances, [redacted] obvious 25X1
opportunities for export are frequently ignored even when a market for the particular product is assured. [redacted] 25X1

External Hindrances to Nonoil Exports

Besides persistent internal problems that hamper Mexico's export drive, protectionist measures enacted by importers and competition from other producers are also having an effect. Mexico's refusal to join the General Agreement on Tariffs and Trade (GATT) gives it little recourse against trade measures such as market allocation arrangements, environmental controls, and antidumping legislation enacted by its trading partners. Reporting from US Embassy [redacted] 25X1
[redacted] *sources suggest Mexican businessmen are* 25X1
unwilling to support membership because it would entail abandoning subsidies and their own high tariff 25X1
barriers against imports. We believe de la Madrid is unlikely to push for joining GATT after spending so much political capital maintaining Mexico's politically unpopular IMF program. [redacted] 25X1

Mexico also is facing growing competition from both established producers and new, low-cost Third World producers anxious to expand their own export base. For example, Mexico, the largest producer of fluorspar, used in steel and glass industries, is losing its market share because it refuses to discount prices in 25X1
the face of an excess world supply. According to a 25X1
business publication, South Africa and China—the latter a new producer—are sharply discounting their prices and picking up new sales. Trade publications also indicate China will provide increasing competition in textile sales while export-processing zones in low-wage Caribbean countries may attract some electronics and textile firms away from Mexico's border industry program. [redacted] 25X1

A Mexican cartoon suggests that the GATT will swallow up poor countries that fall prey to its "free trade" tune

The financial crisis has limited the de la Madrid administration's ability to overcome the inadequacies in the country's transportation system and shortage of skilled labor. Ambitious port and railway projects that the last administration initiated to facilitate exports will now be completed only if they are well under way or if there are negligible foreign exchange costs.

Even with the decline in economic activity, skilled labor is in short supply. The financial press reports that most firms have not laid off management and technical personnel even when plants are operating at sharply reduced levels. In industrial centers like Monterrey, managers and technically skilled employees are frequently pirated by competing firms. According to the US Embassy 25X1
border industries—assembly firms that export finished goods under special tariff concessions—are experiencing a shortage of both skilled and unskilled workers. 25X1 25X1

Mexican officials and World Bank studies project that skilled labor will be a scarce resource as the domestic economy recovers. Training programs will be unable to keep pace with a rapidly growing labor pool and the need for increasingly sophisticated job skills in export-oriented industries. 25X1

Nonoil Exports Over the Medium Term

The Model's Projections

Using the CIA econometric model, we have analyzed export performance under various exchange rate policies and demand conditions during the remainder of the de la Madrid administration.[4] All scenarios assume that Mexico City remains in reasonably close compliance with the IMF program and retains access to essential foreign credit. Implicitly, we have also assumed that relations with the private sector—both domestic and foreign—do not deteriorate further. 25X1

In our most likely case, exchange policy leads to a slightly overvalued peso. Mexican officials do not want to fuel inflationary expectations in a skittish public by making abrupt changes in the exchange rate. We believe the administration is likely to make only small adjustments when the divergence between the exchange rate set by the Bank of Mexico and the rate along the US border become too wide to ignore. De la Madrid's stated desire to increase imports and not add to the private sector's debt burden will also slow exchange adjustments. 25X1 25X1

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[4] See appendix B for a discussion of the CIA econometric model of Mexico and details of the scenarios used in this paper. 25X1

Table 2
Nonoil Export Growth:
Alternative Exchange Rate Policies

(Percent Change From Previous Year)

	Most Likely [a]		Adjusting for Mexico-US Inflation Differences [b]		Overvaluation [c]	
	1984	1985	1984	1985	1984	1985
Total nonoil exports	**17**	**10**	**18**	**14**	**13**	**7**
Manufactures	19	12.5	20	17	17	9
GDP growth rate	−2	0.8	−1.3	4.6	−6.4	−2.5

[a] Assumes peso is devalued at 40-percent annual rate in 1984 and 30 percent in 1985.
[b] Assumes peso is devalued at a rate determined by purchasing power parity, that is, the difference between inflation in the United States (Mexico's principal trade partner) and Mexico. We have calculated rates of 50 percent in 1984 and 40 percent in 1985.
[c] Assumes the peso depreciates at only a 30-percent annual rate in both years.

[redacted] 25X1

Under this scenario we conclude that nonoil export growth will peak at 17 percent this year and then remain close to 10 percent through the de la Madrid administration. After 1984, domestic demand will reabsorb some production that had shifted to external markets. While this growth rate is a substantial improvement over that of previous administrations and would boost nonoil exports 90 percent in 1983-88, it is considerably below de la Madrid's goal of quadrupling nonoil exports. He could, however, come close to meeting the recently announced target of doubling nonoil exports. [redacted]

Alternatively, Mexico City could adjust the exchange rate to reflect actual differences in US-Mexican inflation. In this case, a realistic exchange rate would allow Mexico City to push nonoil exports up 15 percent annually in the next four years and easily exceed its goal of doubling nonoil exports by 1988. If, on the other hand, Mexico City let the peso appreciate sharply, there would be a steady deterioration in export performance. [redacted]

Nonoil exports also could perform significantly worse than any of our scenarios assume, particularly if Mexico City responds to fears of burgeoning political unrest or yields to pressure from the left wing of the ruling party for rapid reflation. A dramatic shift to nationalistic economic policies is most likely to be accompanied by further nationalizations, substantial tightening of government controls, and a loss of essential foreign financing. Such radical changes would be likely to cause a near repeat of the 1982 crisis and stopgap corrective measures would have to be instituted. [redacted] 25X1

Policy Questions

In our judgment, the maintenance of realistic exchange rates and chipping away at other inefficiencies will only do so much over the medium term. To realize export gains beyond those that exchange rates can generate would require some fundamental reshaping of Mexican policy. Businessmen—particularly exporters—are wary of government intentions and are declining to make large investments. According to embassy reports, they believe their dialogue with de la Madrid and his top policymakers has produced little change in the government's statist drift, and that their own role is uncomfortably ambiguous. For example, although private business is represented on the administration's Mixed Advisory Commission on Foreign Trade Policy, a number of corporate observers believe

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A leftist political cartoon entitled "Partners" shows a domineering private sector reminding Commerce and Industry Secretary Hernandez that they hold the most stock in the economy; businessmen would reverse the picture and show a giant ringmaster cowing the lion [redacted]

this has not changed business leaders' conviction that policy continues to discount the private sector and its role in exporting. Press reports also suggest that even the recent steps to return to private ownership many of the nonfinancial businesses taken over when Mexico nationalized the banks in 1982 have not gained much good will, since many firms incurred steep losses while under government management. Such concerns are compounded by the fact that most firms that did turn to exports to offset the sharp plunge in domestic demand in 1983-84 viewed it as a temporary move according to embassy [redacted] sources; 25X1
Mexican businessmen hope to redirect sales to the more profitable domestic market as soon as the economy recovers. [redacted] 25X1

At present most signs point to continuing private-sector concern. [redacted] there is a growing debate in the economic Cabinet concerning future economic policy direction that we believe also will retard new private investment in export industries. The June 1984 National Plan for Financing Development (PROFIDE), prepared by treasury officials, sharply criticizes past policy and appears to support less direct government control of the economy. On the other hand, the July 1984 National Program for Industrial Development and Foreign Trade (PRODICE), formulated by officials in the Commerce Ministry, calls for the government to remain paramount in setting public- and private-sector investment goals. So far de la Madrid appears to be siding with those favoring more state control as recent policy statements continue to emphasize the state's role as "rector" of the economy and insist that his administration is not seeking unanimous support for its policies from business. [redacted] 25X1 25X1

The impact that a further statist drift would have extends beyond the local economy. In our view, Mexico will also have to add consistency and predictability to its policies on foreign investment in order to attract investment into export producing enterprises. Mexico's attitudes toward foreign investment have varied widely with the immediate need for foreign capital. In the first half of 1983, for example, as the magnitude of Mexico's foreign financial predicament became evident, officials mounted a vigorous campaign to attract foreign investment and hinted that the foreign investment laws would be interpreted liberally. As the foreign exchange crunch has eased, 25X1 25X1

Conflicts Over Foreign Investment

While President de la Madrid has indicated publicly a desire to increase foreign investment, actions in his first 22 months in office have sent mixed signals to potential investors in export-oriented industries. In the first half of 1983, Mexican officials mounted a vigorous promotion campaign promising changes in the operating environment for foreign firms, which would have made investment in export-oriented production more attractive. The government-influenced press played as a major policy statement a June 1983 speech by Commerce Secretary Hernandez to the American Chamber of Commerce of Mexico stressing the need for foreign investment. Despite the rhetoric, however, officials were careful to state that, while they were promising new policies, the highly nationalistic Foreign Investment Law itself would remain intact. [redacted]

New foreign investment guidelines, issued in February 1984, also are an attempt to attract, selectively, new investment in possible export production. According to US Embassy and press reporting, the new guidelines specify 34 priority areas—including communications, computer, oilfield, and petrochemical equipment—where foreigners are allowed majority control, rather than the usual 49-percent ownership interest under the Foreign Investment Law. Special attention is given to labor-intensive industries that produce exports. Mexican officials indicated foreigners will be permitted to increase their participation in established Mexican firms if new capital investment is essential to the firm's survival. Proposals for new investment must still be approved by the Foreign Investment Commission, however, and no shortcuts were promised in these guidelines. [redacted]

As Mexico's foreign exchange crunch has eased, however, the administration has played down foreign investment even at the expense of further dampening exports. [redacted] *. Recently issued or pending decrees limiting foreign involvement in the automobile, pharmaceutical, electronic and computer, and food processing industries show that the statists are winning the policy debate.* [redacted]

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Despite these restrictions, we expect most established foreign firms to use their bargaining power as large employers to create a tolerable operating climate. Trade statistics indicate that these firms, with the advantage of well-established market channels, account for a large share of the increase in manufactured exports, despite their small share in total investment, and Mexican industrial policy statements indicate the government is aware of this. These firms will cut deals, such as the recent agreement between a US automaker and the government, that bend implementing regulations and satisfy both the home office and the Mexican administration. [redacted]

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Many potential new investors, reviewing the record of progressively stricter regulation, have told Embassy and financial press sources that they fear that flexible arrangements negotiated now will be subject to new rules when the economy improves. Nevertheless, some firms—computer industries are a good example—will invest in Mexico because it offers relatively cheap labor, proximity to their primary market, the United States, and an export base for penetrating other Latin and industrial country markets. [redacted]

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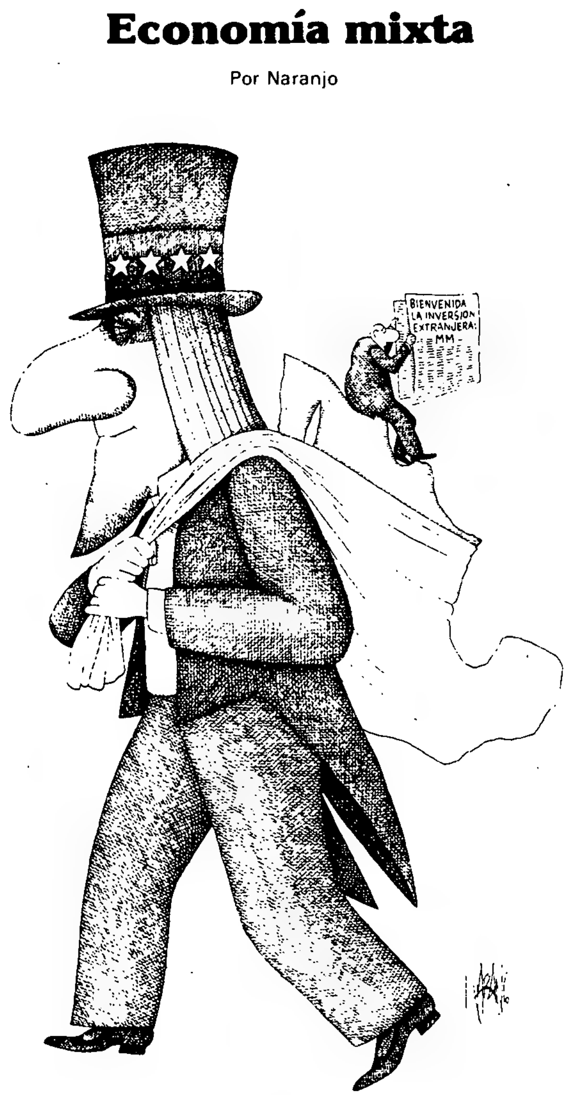

A leftist publication provides its vision of the result of de la Madrid's foreign investment policy

deep ideological divisions have emerged among government officials about the role of foreign investment in the economy, Potential new investors, according to embassy and press sources, fear a tightening of rules when the economy improves. 25X1

Implications

As long as the Mexican Government is unwilling or unable to shift its policies toward the kind of external-oriented development that characterizes, for example, South Korea or Taiwan, its nonoil export prospects will be constrained. The economy will continue to be pulled by swings in oil markets, world demand for its limited number of other exports, and bankers' willingness to continue to supply credit to cover current account deficits. 25X1

In the short run, the major impact of a static nonoil export sector will be felt on the bilateral trade front. At a minimum, persistent financial strains unrelieved by growing nonoil export earnings are likely to cause Mexican officials increasingly to put the blame on their trading partners rather than on domestic factors, where it belongs. The United States will be the most obvious target. Despite the current huge trade surplus with the United States, Mexico City sees still better access to the US market as essential for economic recovery. Mexico's surpluses and some new competitive inroads have sparked numerous trade suits by US producers against Mexican exports such as steel and ammonia. At the same time, senior Mexican officials, including President de la Madrid, have chided the United States on several occasions for what they call "growing protectionism." 25X1

Despite this rhetoric, during the last two years US imports from Mexico have increased about 20 percent. At the same time, US exports to Mexico dropped nearly 50 percent. As a result, the United States had an $8 billion deficit with Mexico last year, in sharp contrast to previous surpluses. Using the Department of Commerce standard estimate that 25X1 each $1 billion in US exports means 25,000 jobs, lost Mexican sales cost the United States over 300,000 jobs during the past two years. 25X1

In recent meetings with US officials, Mexicans have 25X1 strongly pressed for a bilateral subsidies pact that 25X1

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Mexico's Trade Partners: Looking Beyond the US Market

We believe prospects for developing major new markets are only slight in the next two years. While Mexico has extensive trade relationships on every continent except Africa, more than three-fourths of its nonoil exports go to the United States. Proximity and established marketing ties are likely to assure the continued prominence of the United States. [redacted]

Most Latin American countries—which one Mexican official described as Mexico's natural long-term market—are cutting imports because of their own financial crises and foreign exchange shortages. Nevertheless, South Americans pledged to increase intraregional trade in Quito last January, and President de la Madrid included trade issues on the agenda of his South American trip this spring. To avoid the use of scarce dollars, Mexico City set up reciprocal credit lines for $50 million with Brazil and Argentina and for $20 million with Colombia. Mexico and Brazil, its largest Latin trading partner, also agreed to modify existing credit arrangements to clear up payment problems and pledged to try and expand trade to $2 billion by 1985. De la Madrid initialed agreements to purchase Argentine grain and oilseeds and to import Colombian coal in exchange for Mexican manufactured goods. While we do not expect a dramatic increase in exports to the region, we believe that sales will expand to the larger countries. The peso devaluation, lower dollar wage rates, and Latin American Integration Association (LAIA) tariff provisions are likely to prompt some multinational firms to use Mexico as an export platform for Latin sales. [redacted]

New sales to non-Latin developing countries show little promise because of those nations' financial difficulties and small domestic markets, and Mexico's lack of marketing experience. Transportation costs eliminate some of Mexico's price edge in competing with traditional LDC suppliers in Europe and Asia. Recently, Mexican firms have sold petroleum equipment to India and Volkswagen kits to Nigeria. Many LDCs, however, have instituted export campaigns of their own and are more likely to be competitors than customers. [redacted] 25X1

Oil exports gave Mexico a positive trade balance with several industrial countries in 1983. Concern over deteriorating trade balances with newly industrialized LDCs has prompted several industrial countries to erect substantial tariff and other trade barriers. Moreover, many of the items Mexico can quickly bring into the international market—car parts, steel, textiles, and shoes—face stiff competition from depressed OECD and other Third World industries. Nevertheless, Mexico City has actively promoted some exports, particularly processed foodstuffs, in Europe and Japan and economic recovery in industrial economies should prompt some increase in trade. Mexico has succeeded in increasing steel and mineral exports to Japan, in part because of Japanese coinvestment in these industries. Recently expanded port facilities on the Pacific coast also will facilitate greater trade with the Far East. [redacted] 25X1

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Prospects for increasing trade with other oil-exporting nations and centrally planned economies are mixed at best. Mexico City hopes to increase sales in the Arab states, and its cooperation with OPEC on price and supply issues has won it favor. Mexican exporters have successfully marketed steel products in Saudi Arabia and plan to push sales of pharmaceuticals, office equipment, electrical products, and fruit juices, according to a spokesman for private-sector exporters. Mexican trade with the centrally planned economies is likely to remain small, although the Soviets and East Europeans have shown mounting interest in barter deals. According to press reporting, Mexico and the Soviet Union negotiated a barter arrangement earlier this year that involves exchanging Mexican specialty steel products for Soviet steel technology. [redacted] *most other proposals involve offers of machinery and technical assistance in exchange for Mexican textiles, foodstuffs, minerals, or chemical products. Mexico City has reacted coldly to proposals that call for oil in exchange for goods.* [redacted] 25X1

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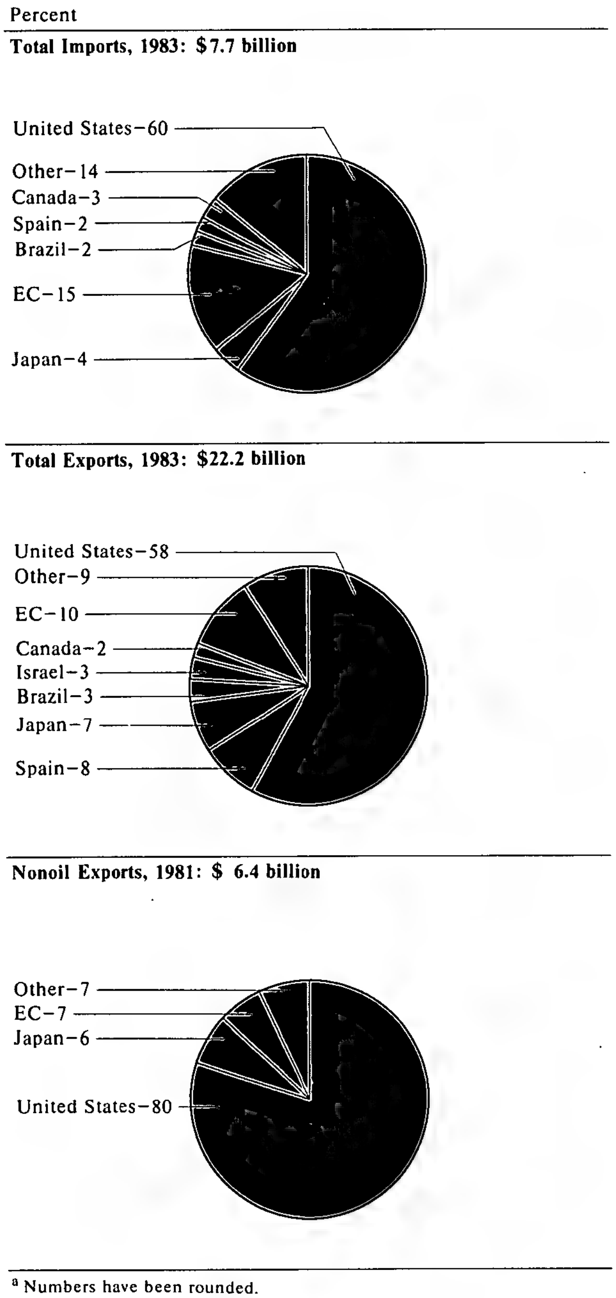
Figure 2
Mexico: Principal Trade Partners[a]



[a] Numbers have been rounded.

[redacted]

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would grant Mexican exporters an "injury test"[5] when countervailing duty suits are reviewed. At present, US producers only need to demonstrate the export benefits from government subsidies; they do not have to prove their sales have been adversely affected. Mexico, in our view, also fears that the Trade Remedies Reform Act, now being discussed in the US Congress, could make it even easier to file countervailing duty suits and would prohibit "natural resource subsidies" that benefit ammonia and other petrochemical exports. We believe recent measures taken by Mexico, including the substantial hike in interest rates on export financing and the proposed 35-percent reduction in steel exports to 395,000 metric tons annually through 1987, signal its desire to speed up negotiations. [redacted] 25X1

Mexico City is also lobbying for renewal in 1985 of the US GSP—a program that allows duty-free entry of nearly 3,000 LDC products. The pending legislation would extend the program for 10 years, but establish a stricter competitive need formula that could be waived in exchange for some reciprocal trade concessions for US exports. According to US Embassy reports, Mexican officials believe this legislation would cut Mexico's GSP benefits by two-thirds.[6] Mexico City opposes any reciprocity provisions, and the US Embassy's sources believe Mexico would be unwilling to grant increased market access in return for broader GSP coverage. Mexican officials would like the United States to drop the competitive needs test and the provision that pushes more advanced LDCs out of the GSP program. Mexico City has also requested that US inputs be counted in determining the 35-percent local content requirement. [redacted] 25X1

In our judgment, structural changes in the Mexican economy and maintenance of the peso's competitiveness would contribute more to assuring healthy sales to the United States than a more liberal GSP or a

[5] Under US trade law, the "injury test" can only be granted to countries that are signatories of the GATT Subsidies Code. While it is not a signatory, the subsidies treaty contains a provision exempting Mexico [redacted] 25X1
[6] Mexico, the fourth-largest beneficiary of the GSP program, received over 7 percent of all GSP benefits in 1982. According to an OAS publication, about half of the Mexican products initially eligible for GSP were excluded under the current competitive need formula in 1982. [redacted]

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bilateral trade treaty.[7] While it appears to us that countervailing duties have had a minimal economic impact on Mexican exports and GSP benefits extend to only a small percent of Mexico's exports, Mexican officials and private-sector spokesmen say these measures have a significant psychological impact on Mexican exporters. US trade actions receive wide—and often negative—press coverage in Mexican journals. The elimination of 55 items from GSP coverage in early 1983 was labeled an "unfriendly act" in the Mexican press, which called the measure an attempt to pressure Mexico City to change its Central American policy. [redacted] 25X1

Over the longer term, we believe Mexico's inability to substantially boost nonoil exports will create troublesome problems well beyond the bilateral level. The strong balance-of-payments position we project for the next two years is based largely on continued depressed import levels and masks the still precarious health of the overall economy. In even the most favorable scenario, projected increases in nonoil export earnings would only slightly ease foreign financing requirements through 1988. While recently renegotiated debt repayment schedules will help, heavy interest obligations (more than $12 billion per year) will continue to absorb more than half of Mexico's merchandise export earnings throughout de la Madrid's term. [redacted] 25X1

Given new estimates by the US Department of Energy of lower oil reserves, we believe future oil revenues will be lower than planned and de la Madrid will find his policy choices increasingly constrained.[8] We foresee only a slim chance that de la Madrid would buck the bureaucratic establishment and institute the structural changes needed to encourage private investment and promote competitive industries. Domestic support for such deep revision is limited to a handful of government officials and a small segment of the private sector. For example, dismantling longstanding protectionist policies would increase business failures and add to already high unemployment. Despite long-run benefits, we believe de la Madrid would avoid this now, with important midterm federal and state elections coming up in 1985. More likely, the President will turn to traditional populist policies, acceptable to most key interest groups, and use government spending to reflate the economy. Too broad-based a reflation, however, would renew balance-of-payments problems, reignite inflation, and alarm international creditors. These circumstances could bequeath de la Madrid's successor with another financial and economic crisis. [redacted] 25X1

[7] Elimination of special tariff provisions covering exports from border industries would have a significant impact, however. According to US trade figures, imports from border industries accounted for 22 percent of Mexican exports to the United States in 1983. [redacted] 25X1

[8] DOE/EIA/0423, *The Petroleum Resources of Mexico, Foreign Energy Supply Assessment Series,* October 1983.

Appendix A

Past Failures in Nonoil Export Promotion

In the early 1960s Mexico began to take steps to overcome traditional obstacles to export promotion such as exchange problems, antibusiness bias, and bureaucratic snarls. The government's moves included reduced export duties, tax rebates on foreign sales with at least 80-percent domestic content, membership in the Latin American Free Trade Association, the Border Industry program, and the creation of FOMEX, a trust fund to assist in financing manufactured exports. In the 1970s Mexico City broadened its assistance to exporters by extending the tax rebate system to all exporters, not just producers, and easing Mexican content requirements. Realizing that high domestic interest rates and the traditional short lending terms offered by the Mexican banking system were also penalizing exporters, Mexico expanded financing to compete with the export assistance programs of developed countries. [redacted]

Nevertheless, strict requirements, the complicated tax rebate system, and the practice of selectively hiking export duties when domestic shortages were feared dampened the enthusiasm of potential exporters. On balance, incentives continued to favor import substitution, and most manufacturers took the easy route and produced for the home market. Moreover, Mexico allowed the peso to become gradually overvalued in the mid-1970s, making Mexico's exports unattractive to foreign buyers. [redacted]

The success of import substitution policies in pushing an economic expansion that averaged over 6.5 percent annually in 1951-81 also undercut the export drive. Successive administrations used a variety of investment incentives and protective trade measures to encourage manufacturing for the domestic market. Extensive import licensing, which covered 80 percent of foreign purchases by the mid-1970s, was the government's most effective tool. The strong peso subsidized capital importers, while import licenses protected the domestic consumer market. The government, occasionally in conjunction with the private sector, also increased its investment in industries considered essential to development, such as fertilizers, petrochemicals, iron, and steel. [redacted]

In addition, other programs to aid exporters often went unnoticed or failed to meet the needs of those they were designed to serve, according [redacted] a World Bank survey. For example, a World Bank report calls Mexico's National Council on Science and Technology the most sophisticated in the Third World, but criticizes its research and development effort as divorced from the needs of Mexican industry. Another World Bank study found that technology absorption was generally a function of the firms' own initiative rather than the result of a wide variety of government programs. [redacted]

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Lopez Portillo's Initiatives

Despite an increase in export incentives, overall policy in the Lopez Portillo administration continued to skew private-sector investment in favor of import substitution and production for the home market. His 1980 Global Development Plan (PDG) called for imports to increase faster than exports and emphasized funding resources for public-sector investment rather than the private sector. The plan did not discuss exchange rate strategy and assigned a low priority to controlling inflation. In his fifth state of the union address in September 1981, Lopez Portillo called for manufacturers to concentrate on import substitution because of the unreliability of foreign markets. He disavowed a relationship between the exchange rate and Mexican competitiveness. Although the President began negotiations to join the General Agreement on Trade and Tariffs (GATT), he withdrew in the face of strong opposition from a number of domestic interest groups, including members of his administration. [redacted]

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Even so, rhetoric in the Lopez Portillo administration attached great importance to the expansion of manufactured goods exports. Both the 1979 National Industrial Development Plan (NIDP) and the 1980 PDG called for greater subsidies and tax concessions for

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industry and exporters were given generous tax rebates, tax credits, subsidized credits from FOMEX and other government funds and subsidized input prices especially for fuel.[9] The number of controlled imports was also reduced sharply, although restrictions on only 40 percent of imports in terms of value were affected. Nevertheless, a World Bank study concluded that industries facing increased external competition because of trade liberalization early in the Lopez Portillo regime, including textiles and other nondurable consumer goods, did respond with new investment efforts to improve quality. [redacted]

Despite government efforts to boost nonoil production and exports, credit available to the manufacturing sector fell in the late 1970s in part because of the emphasis on rapid oil development. By 1982, bankers were required to set aside 54 percent of deposits as reserves, making a vast pool of funds available only to the public sector. Mandatory credit allocation schemes and other requirements further limited resources available to business. By 1982, 86 percent of commercial bank lending was directed to particular sectors by the government. Banks charged high interest rates on their nondirected loans to balance the low rates required under the mandatory programs. Nearly half of bank loans were extended to firms in Mexico City, according to a World Bank study, despite the decentralization goals of the NIDP. [redacted]

In addition, the extensive government incentive programs focused on Mexico's natural resource endowments—favoring scarce capital resources over abundant labor. Energy and input subsidies and fiscal incentives encouraged the private sector to invest in capital-intensive industries—chemicals, basic metals, and nonmetallic minerals. Subsidies for employment generation were less attractive because they were generally based on the minimum wage, which represents only a fraction of a worker's total compensation. Various subsidized interest schemes also made capital costs cheaper, while mandatory contributions to the Social Security System, the government housing fund, and other costs associated with such labor laws as severance pay and Christmas bonuses added to the cost of labor. [redacted] 25X1

Perversely, the import substitution schemes also tended to increase local costs and reliance on imports. Potential exporters faced problems of higher input costs because of measures to protect local producers, including official prices above world prices and import quotas and licenses. Incentives to local producers favored production of final products over intermediate and capital goods, despite the government's rhetoric about creating a domestic capital goods industry. [redacted] 25X1

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[9] According to a World Bank study, manufacturing industries' (including petroleum and basic petrochemicals) share of transfers and subsidies was 17.5 percent in 1980 with subsidized input prices being the largest single subsidy (10 percentage points of 17.5 percent). The chemical and food-processing industries were the largest recipients. [redacted] 25X1

Appendix B

Notes on the CIA Econometric Model of Mexico

The CIA econometric model of Mexico was used to derive economic projections for 1984 and 1985.[10] The model combines a theoretical representation of the Mexican economy, a statistical analysis of the key relationships, and assumptions about government policies and external events in a system of equations. Solving the model produces conditional estimates of the future; comparisons of separate runnings under different assumptions can be used to determine the sensitivity of the economy to alternative future conditions. [redacted]

Using historical data from Mexican Treasury and Central Bank publications, the IMF, and the World Bank, we examined nonoil export performance under alternative exchange rate and US growth assumptions.[11] We assumed that Mexico maintains IMF support and access to foreign credit, increases imports, and has stable relations with the private sector. The effect of alternative exchange rate and US growth assumptions on Mexican economic activity, nonoil exports,[12] and the current account is shown in table 4. Table 5 compares estimates from other econometric services. [redacted]

In general, the CIA model shows that the Mexican economy is most sensitive to movements in the exchange rate, while changes in US economic growth result in smaller improvement or worsening of the economic variables we examined. In part, this reflects the immediate reduction in the foreign exchange price that a peso devaluation makes in Mexican goods, while there is a lag before higher economic growth abroad translates into a general expansion in consumer demand. Because the peso moves with ease back and forth along the border, Mexico is directly affected by US monetary policy through its exchange regime. Devaluing the peso nearly 10 percentage points faster in 1984-85—using our calculation of the difference between Mexican and US inflation rates—produced dramatic improvements in growth and nonoil export performance. The economic decline slows substantially in 1984, and economic growth approaches 5 percent in 1985, exceeding Mexico City's optimistic 3- to 4-percent growth projection. Nonoil export sales also jump by nearly 2 and 5 percentage points in 1984 and 1985, respectively. The model demonstrates that an overvalued exchange rate is a drag on the economy. If the peso appreciates significantly, economic activity declines in both 1984 and 1985. [redacted]

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The high US growth rate and purchasing power parity scenario results in the sharpest overall improvement in the economy. An overvalued exchange rate combined with low growth in the United States represents the worst case and mirrors the real situation in the 1980-81 period. Then, the US recession and the overvalued Mexican peso caused Mexican manufactured goods exports to decline in real terms, not just as a share of total exports [redacted]

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[redacted]

[11] US data used to solve the base case came from Data Resources, Inc. econometric Model of the United States. [redacted]

[12] The rate of change in agricultural and mineral exports is set exogenously in the model. Since prices of key agricultural and mineral exports are set on the world market in dollars, changes in exchange rate policy have little effect. Growth in developed countries will raise demand for industrial minerals and higher priced agricultural products such as coffee, beef, and shrimp. The model does make some adjustments in agricultural exports based on US growth rates. Manufactured exports are determined by the model. [redacted]

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Table 3
Mexico: Nonoil Exports Scenario Comparisons

	Scenario 1 [a]			Scenario 2 [a]			Scenario 3 [a]		
	Base	High	Low	Base	High	Low	Base	High	Low
1984									
GDP growth rate (*percent change*)	−2.00	−1.39	−4.21	−1.34	−1.03	−1.83	−6.37	−6.08	−6.86
Nonoil exports (*billion US $*)	7.07	7.09	7.00	7.17	7.19	7.20	6.97	6.99	6.98
Percentage change	16.76	17.09	15.08	18.39	18.72	16.78	13.08	13.41	13.36
Current account balance (*billion US $*)	1.33	1.35	1.35	2.14	2.16	2.17	0.47	0.49	0.49
1985									
GDP growth rate (*percent change*)	0.80	1.57	−0.08	4.60	5.39	3.76	−2.47	−1.73	−3.29
Nonoil exports (*billion US $*)	7.77	7.86	7.77	8.16	8.26	8.16	7.46	7.55	7.46
Percentage change	9.92	10.90	9.52	13.85	14.87	13.47	7.12	8.05	6.75
Current account balance (*billion US $*)	0.52	0.53	0.65	2.38	2.41	2.52	0.18	0.18	0.05

[a]

Alternative Exchange Rate Scenarios *(Percent change)*

	1984	1985
Scenario 1: Most likely	40	30
Scenario 2: Purchasing power parity	50	40
Scenario 3: Overvaluation	30	30

Alternative US Growth and Inflation Rates *(Percent change)*

	1984		1985	
	GNP	Inflation	GNP	Inflation
Base	5.75	4.6	2.8	5.94
High	7	3.5	5	4.5
Low	1	8	1	8

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Table 4
Forecasts of Economic Variables

	1984			1985		
	GDP (*percent change*)	Nonoil Exports (*percent change*)	Current Account Balance (*billion US $*)	GDP (*percent change*)	Nonoil Exports (*percent change*)	Current Account Balance (*billion US $*)
DRI [a]	1.3	7.2 [d]	0.3	3.3	12.0 [d]	0.9
WEFA [b]	2.0	13.0	0.6	4.6	17.0	−2.9
Chase [c]	0.3	14.0	2.3	3.3	9.0	0.26
CIA	−2.0	16.8	3.7	0.8	9.9	1.8
GOM	0	20.0	3.8	NA	NA	NA

[a] *Latin American Forecast Summary,* Data Resources, Inc., summer 1984.
[b] *World Economic Outlook,* volume VI, number 1, Wharton Econometric Forecasting Associates, May 1984.
[c] *Latin American Forecasts and Analysis,* first quarter 1984, Chase Econometrics, March 1984.
[d] All merchandise exports, including oil.

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Table 5
Frequently Used Acronyms

BANCOMEXT	Foreign Trade Bank
FIC	Foreign Investment Commission
FICORCA	Trust Fund To Cover Foreign Exchange Risk
FIL	Foreign Investment Law of 1973
FOMEX	Trust Fund for the Promotion of Manufactured Exports
GSP	Generalized System of Preferences
IMCE	Mexican Institute of Foreign Trade
NAFINSA	National Development Bank
NDP	National Development Plan 1983
NIDP	National Industrial Development Plan 1979
PDG	Global Development Plan
PRODICE	National Program for Industrial Development and Foreign Trade
PROFIDE	National Program for Financing Development

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